Flexible Tax Strategies Now Needed in Succession Planning for Business Owners

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The most popular tax strategy in succession planning over the past 35 years has been to create minority interest discounts in an effort to lower the value of the client's business for federal estate and gift tax purposes. With federal estate tax rates as high as 70 percent during this period, and with a federal estate tax exemption as low as $175,000, this strategy no doubt made common sense.

This raises the obvious question: With a federal estate tax exemption currently over 30 times its 1981 level, does it still make sense to focus exclusively on creating minority interest discounts as the best succession planning tax strategy? And what, if any, is the relevance of the IRS' announcement last year that it is about to clamp down on family discounting techniques? Of what effect is President Obama's proposal last year to potentially deem certain (as yet unknown) closely-held business owners as having sold their interest in the business at death or upon an earlier gift of an interest in the business?

Far less than half of all family businesses survive to the third generation, which means that a significant percentage of closely-held businesses are sold at some point during the second generation's lifetime. Given all of the above, for most closely-held businesses does it still make sense to adopt a strategy of creating minority interest discounts, or is a more flexible tax strategy for succession planning now in order?

ONE BASIC PLANNING IDEA

Assume, for example, that in 2005 a family created a basic discounting technique by having the husband and wife each gift 0.5% of their respective 50% interests in the company to their children. The business is currently worth $6 million on a majority basis, but less than $4 million on a minority basis. The balance of the parents' estate is worth approximately $2 million. Is this succession plan still a good one? If not, what can be done about it now, to make it better?

The problem is that although the plan should help avoid estate taxes for the parents, assuming the parents utilize a traditional two-trust approach for a husband and wife, it may also cause a loss of full income tax basis step-up for the company shares (i.e., from their control premium value) at the parents' death. This loss of full income tax basis step-up may be unnecessary because the parents' combined taxable estate, had they retained all of the stock, would have been approximately $3 million less than their combined federal estate tax exemptions.

A simple yet flexible strategy to avoid this result would be for the children to gift the 1% stock back to the parents, leaving them each with 50% control of the company. There would be some taxable gift by the children to the parents (potentially covered by the annual gift tax exclusion), when the former transferred their interests in the company back to the parents.

The total value of the parents' estate would then be over the current federal estate tax exemption amount. Unless they were willing to gamble that the spousal portability election would protect the survivor from estate tax, they would still need to fund two separate revocable trusts. Each would fund their separate trusts with half of the stock in the company and with $1 million in assets other than the stock. For most small business owners this simple step of returning the parents to their original ownership positions in the company will be enough to avoid estate taxes while simultaneously avoiding minority interest discounts in the inherited income tax basis of the shares. The revised tax strategy for the parents' succession planning would end here.

But there is a potential problem for many closely-held business owners: the surviving spouse could still end up with a taxable estate, depending on the value of the company (and other separate assets) and the size of the federal and estate tax exemptions at the survivor's death. Also, the plan may not maximize the income tax basis of the shares at the surviving spouse's death, because half of the shares would be in the bypass or credit shelter trust. What can be done to improve this situation?

Here is just one thought:

Husband and wife each gift shares in the company to one or more irrevocable trusts for their children sufficient to cause each of the spouses to become a minority owner in the company (e.g., 0.5% each). The couple's estate plans then each establish a bypass or credit shelter trust for the other, funded with each of their remaining interests in the company and other assets.

The irrevocable trusts for the children are for the latter's sole and exclusive benefit, and the trustees are given the sole and absolute power to make distributions of income and principal to the children. However, each grantor retains a conditional testamentary general power of appointment over the balance of the trust assets at death, to their respective estates.[1] Under IRS Chief Counsel Memorandum 201208026[2], each spouse makes a taxable gift of the full value of the stock transferred to the irrevocable trust or trusts, despite the conditional testamentary general power of appointment.

Husband and wife should not serve as trustees of the irrevocable trust or trusts, although they may retain the ability to remove and replace the trustee with another independent trustee.[3] The ability to remove and replace the trustee, without causing automatic estate tax inclusion in the grantor's gross estate, is obviously important in business succession planning, where retained influence on the part of the older generation is usually one of the goals.

The general powers of appointment are conditional in that they are only exercisable to the extent they will not raise the value of the transferor spouse's taxable estate plus adjusted taxable gifts over the federal (or state, if lower) estate tax exemption level at the time of his or her death. This in turn should cause this portion of the trust, and only this portion, to be included in the transferor's spouse's gross estate, under IRC Section 2038.

It is vital that the retained conditional testamentary general power of appointment in the grantor spouse be a full general power of appointment, i.e., not one limited to the creditors of the grantor spouse's estate. Based on the Fifth Circuit's decision in Estate of Bonner v. United States,[4] if at the time of the decedent's death his or her estate lacked control over the disposition of the trust assets such that it could act as a hypothetical seller negotiating with willing buyers free of the limitations associated with fractional undivided interests, the trust assets will not be aggregated with the decedent's own assets for valuation purposes. Limiting the grantor spouse's retained testamentary general power of appointment over the children's trusts to the creditors of the grantor spouse's estate only presents the potential for the IRS to argue that the shares of the two trusts, while aggregated for estate tax inclusion purposes, should not be aggregated for estate tax valuation purposes.

After factoring in the potential Section 2038 inclusion in the surviving spouse's gross estate for the value of the children's irrevocable trusts, the surviving spouse is then also granted a conditional testamentary general power of appointment (to his or her estate) over the remaining trust assets in the bypass or credit shelter trust, again limited so that the total amount included (after first factoring in the value included for the children's trust or trusts) will not cause the surviving spouse's taxable estate plus adjusted taxable gifts to exceed the federal estate tax exemption (or state estate tax exemption, if lower) level at the time of his or her death. This second step in effect creates a control premium for all the shares which are includible in the surviving spouse's gross estate at death, thus increasing their income tax basis step-up potential beyond a mere 50% ownership value.

Assume, for example, that the husband dies with the 49.5% interest in the company, and that this interest passes to the bypass or credit shelter trust for the wife. Wife later dies with her independent 49.5% interest. Assume also that, when the wife dies, the company is worth $5 million on a control basis and $3 million on a minority basis. Finally assume that the size of the estate tax exemption is $7 million at the time of the wife's subsequent death, and that she owns $2 million in other assets at that time.

Because the wife's conditional testamentary general powers of appointment are drafted to intentionally avoid the result in Estate of Bonner v. United States, i.e., so that the wife has a full power to appoint the 49.5% interest in the bypass trust and a full power to appoint the .5% interest in the children's irrevocable trust or trusts to her estate, all interests are aggregated into one 99.5% control interest for valuation purposes. The inherited stock receives a $4.975 million income tax basis in the hands of the children. Had the stock been valued as three separate minority interests, the inherited income tax basis would have been only $2.985 million.

One potential negative of allowing the surviving spouse a full power of disposition over all or a portion of the bypass trust at death is that the surviving spouse may then presumably appoint these trust assets to a new spouse, etc. This risk thus needs to be explained to the clients up front. It may also be advisable to authorize an independent trustee or trust protector to pull back on the surviving spouse's general power of appointment over the irrevocable trust or trusts for children, as well as over the bypass or credit shelter trust, in the event the surviving spouse has remarried. This is because maximum utilization of the spousal portability election in the new spouse's estate may then become preferable to income tax basis step-up to the surviving spouse's estate, depending on all the facts and circumstances.

Other conditions may need to be attached to the surviving spouse's contingent testamentary general power of appointment over the bypass or credit shelter trust. For example, the surviving spouse's general power of appointment should normally be over the most appreciated assets of the trust first (which will not necessarily include the shares of stock in the company), and should not be over any trust assets which have depreciated in value. Also, a clause should be included to address President Obama's proposal to tax built-in gains at death, providing that the general power of appointment would not attach to any assets where the proposed tax would be incurred or to any assets which would, as a result of such legislation, carry with them a carryover income tax basis, even if includible in the surviving spouse's gross estate.

Note that the decedent's Section 2038 conditional general power of appointment over the shares of stock he or she transferred to the children's trusts will eliminate the adjusted taxable gift characteristic of the same, under IRC Section 2001(b)(2), provided the conditional power does become effective and the shares are actually included under Section 2038.[5].

A POSSIBLE FURTHER REFINEMENT

The plan outlined above eliminates the minority interest estate tax discount to the transferor spouse where the discount ends up not being necessary, but it does not create a control premium which could further enhance the income tax basis of the shares. This may be relevant where surviving spouse intends to sell the business after the first spouse's death.

A possible solution to this problem would be to grant the first spouse to die an additional conditional testamentary general power of appointment to his or her estate over the stock which was transferred to the children's by his or her spouse, only to the extent that the power will not cause the value of the spouse's estate to exceed the federal (or state) estate tax exemption at the date of death. The first spouse to die would now potentially own a 50.5% control interest in the company for estate tax valuation purposes, potentially significantly increasing the income tax basis of the 50.5% interest in the hands of the surviving beneficiaries.

The conditional general powers of appointment must be applied in two steps, primarily because the estate

tax valuation methodologies at each step are different. The first step is the general power of appointment over the stock that was transferred by the decedent. This puts the decedent's estate in a 50% veto position, and thus is valued differently from a minority position. The second step is the general power of appointment over the stock that was transferred by the decedent's spouse. This now places the decedent's estate in a 50.5% control position, which is valued differently from a veto position.

Under this refined plan, the surviving spouse would also possess a conditional testamentary general power of appointment to his or her estate over the shares of stock that he or she transferred to the children's trusts, as well as over the shares that were transferred to the trust or trusts by the predeceased spouse. This would cause the surviving spouse to potentially also own a 50.5% controlling interest in the company.

The shares in the bypass trust established by the predeceased spouse would be subject to a third conditional testamentary general power of appointment to his or her estate in the hands of the surviving spouse, but again only to the extent the power does not cause the survivor's taxable estate to exceed the federal or state estate tax exemption at date of death.

This third conditional testamentary general power of appointment would apply only after application of the first two conditional testamentary general powers of appointment applicable to the children's trusts. The three separate powers may each be valued differently for federal estate tax purposes, e.g., if the step three general powers give the decedent even greater control over the company than a mere majority interest would provide.

If the surviving spouse remarries, an independent trustee or trust protector may be empowered to further restrict the surviving spouse's powers of appointment to provide additional assurances for the remainder beneficiaries or if it makes more sense to use part of the deceased spouse's unused exemption (DSUE) amount.

ONE MORE POSSIBILITY

In situations where the combined value of the couple's estates is less than the estate tax exemption, a full income tax basis step-up can be achieved at the death of the first spouse to die by allowing each spouse to transfer his or her interest to a joint revocable trust, and then grant each of them a full and unrestricted lifetime power of withdrawal over the entire interest. The entire interest would then continue to be subject to the surviving spouse's right of withdrawal, yet he or she would have received a full income tax basis step-up at the first spouse's death, as a result of a combination of IRC Sections 2038 and 2041.[6].

One may argue that the interest that was transferred to the joint trust by the surviving spouse should not receive a step-up in income tax basis, under the theory that it was gifted to the decedent spouse at the moment of death by the surviving spouse, and then reacquired by the surviving spouse within one year, under IRC Section 1014(e). The problem with this argument is that the surviving spouse never made the Section 1014(e) required "gift" to the decedent spouse, under the IRS regulations.[7]

A similar joint revocable trust basis step-up strategy should also be available to large estates. After first utilizing the valuation discounting technique of transferring a portion of the business to children's trusts, the couple then funds their separate revocable trusts with assets equal in value to at least the federal estate tax exemption amount, and then transfer the balance of their assets (including, to the extent possible, their respective interests in their company) to the type of joint revocable trust described immediately above.[8]

Estates that are larger than one full estate tax exemption, but less than two, may utilize a combination of these strategies, e.g., by only transferring to the joint revocable trust enough of the business interest that will not cause the surviving spouse estate to potentially be subject to estate tax.[9]

POSSIBLE NEED TO EXPEDITE PLANNING

As summarized by Steve Akers in his "2016 Heckerling Musings" outline[10] (beginning at page 22):

> *The §2704 legislative proposal in the Greenbooks for the Obama Administration, ending with the 2013 Fiscal Year Greenbook, includes five items. The new §2704 regulation may include some or all of these subjects. An additional category of restrictions ("disregarded restrictions," which are in addition to the liquidation restrictions addressed in §2704) may be disregarded in determining the value of in-*

terests in "family-controlled entities" (observe, this is not limited just to partnerships and LLCs) that are transferred to family members. What are those additional restrictions? They are "to be specified in regulations." Transferred interests would be valued by substituting for "disregarded restrictions certain assumptions to be specified in regulations. Disregarded restrictions would include limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard to be identified in regulations."

Some planners have expressed concern that the proposed regulation may limit the availability of minority and marketability discounts for transfers involving family- controlled entities.

Given that the IRS proposed Section 2704 regulations may be issued at any time, advisors desiring to seek a minority interest discount for clients with large closely-held business interests (including interests in real estate) should soon, by creating minority interests for their clients, preferably on an irrevocable basis through significant lifetime gifts to irrevocable trusts for children.

And what if President Obama's proposal to tax capital appreciation at death (as well as on gifts) is eventually passed? Although the proposal would defer the gain for "certain small family-owned and family-operated businesses,"[11] the question remains how the phrase "certain small" will eventually be defined. An advisor may therefore consider being proactive by making substantial gifts of closely-held business interests before any serious tax legislation in this area is introduced in Congress.

ONE FINAL THOUGHT

The above-outlined plan involving the establishment and funding of irrevocable trusts for children, while flexible, will not necessarily eliminate all estate taxes at the older generation's death. An additional tax-sensitive strategy of utilizing income and estate tax-exempt life insurance planning, in order to pay any estate taxes that may still be due upon the death of the older generation, should be considered in these situations. Clients should also consider making larger lifetime transfers to children or to a spousal access trust in order to remove future appreciation from the older generation's estate. Any insurance planning program should continue to be coupled with income tax basis step-up planning involving the bypass or credit shelter trust, in order to achieve maximum income tax basis step-up at the surviving spouse's death, as well as with the possible utilization of the joint revocable trust technique described above for achieving maximum income tax basis step-up at the first spouse's death.

ENDNOTES

1 A general power of appointment to the transferor's spouse's estate is required because a limited power of appointment will most likely not result in the aggregation of the stock for estate tax valuation purposes. See Estate of Bonner v. United States, 84 F.3d 196 (5th Cir. 1996).

2 Dated September 28, 2011, and first released on February 24, 2012.

3 Rev. Rul. 95-58, 1995-2 C.B. 191.

4 84 F.3d 196 (5th Cir. 1996).

5 Although it is clear the reciprocal trust doctrine professed by the Supreme Court in Estate of Grace, 395 U.S. 316 (1969), should not apply on these facts, to cause the automatic inclusion of the trust or trusts established by the decedent's spouse in the decedent's gross estate, advisors who are concerned about this issue can include a clause in each trust agreement which voids the spouse's general power to the extent it would cause automatic inclusion in the spouse's gross estate.

6 See, in this regard, J. Blase, "The Minimum Income Tax Trust," Trusts & Estates (May 2014), at pp. 36-39 (available at http://blaselaw.com/yahoo_site_admin/assets/docs/BlaseTrustsandEstatesarticleMay2014revised4914.15493652.pdf).

7 Id. at 37.

8 Id. at 37-38.

9 Ibid.

10 Available at http://www.dallasepc.org/assets/Councils/Dallas-TX/library/Akers%20Handout.pdf.

11 General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals (Department of the Treasury, February 2015), at p. 157.

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